DEPARTMENT OF STATE REVENUE

Revenue Ruling # 2018-01IT
September 5, 2018

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ISSUES

Adjusted Gross Income Tax - Apportionment & Nexus

Authority: IC 6-2.5-1-27; IC 6-3-2-2; IC 6-3-2-2.8; IC 6-3-4-13; 45 IAC 3.1-1-38; 15 USC § 381 (P.L. 86-272); *Wisconsin Dept. of Revenue v. William Wrigley, Jr.,* 505 U.S. 214, 112 S.Ct. 2447 (1992).

A taxpayer ("Company") is seeking a ruling regarding whether its contract to develop software for a manufacturer in Indiana would establish nexus in Indiana, creating a corporate and personal income tax filing obligation with the State of Indiana.

STATEMENT OF FACTS

Company is a Florida S Corporation that, amongst other things, designs custom software for various types of clients. Company provides the following relevant, factual context to its request:

> [Contract Manufacturer based in Indianapolis] would like to hire [Company] on a short-term contract basis to develop a custom software application. The software will be developed in Florida by [Company] and transferred to [Contract Manufacturer]. The software is not off-the-shelf. The software is highly specific to one of the products that they are producing for their customers and can only be used in conjunction with that specific product to facilitate its manufacture. The operation of this software will be formally validated in Florida by [Company], and independently by staff at [Contract Manufacturer], before release to manufacturing. Therefore, only a minimal level of follow-up support is anticipated.
>
> It is not the intent of [Company] to physically set up an office in Indiana or have any employees in Indiana. No business has been conducted between [Company] and [Contract Manufacturer] at this time.
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> . . .
>
> It is not known if this work will lead to additional related or unrelated business with [Contract Manufacturer].

DISCUSSION

Company requests a ruling as to whether it has any corporate income tax obligations by virtue of its transaction with the Contract Manufacturer in Indianapolis. Additionally, as an S Corporation, Company also requests a ruling as to whether the transaction creates a personal income tax obligation.

In general, IC 6-3-2-2(a) defines adjusted gross income from sources within Indiana for corporations and nonresident persons to include:

> (1) income from real or tangible personal property located in this state;
> (2) income from doing business in this state;
> (3) income from a trade or profession conducted in this state;
> (4) compensation for labor or services rendered within this state; and
> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property to the extent that the income is apportioned to Indiana under this section or if the income is allocated to Indiana or considered to be derived from sources within Indiana under this section.

When a corporation derives business income from sources both within and without Indiana, the business income derived from sources within Indiana is determined by an apportionment formula. IC 6-3-2-2(b).

As for the issue of corporate income tax nexus, subsections (e) and (f) of IC 6-3-2-2 provides the following:

> (e) The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. Sales include receipts from intangible property and receipts from the sale or exchange of intangible property. However, with respect to a foreign corporation, the denominator does not include sales made in a place that is outside the United States. Receipts from intangible personal property are derived from sources within Indiana if the receipts from the intangible personal property are attributable to Indiana under section 2.2 of this chapter. Regardless of the f.o.b. point or other conditions of the sale, sales of tangible personal property are in this state if:
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> (1) the property is delivered or shipped to a purchaser that is within Indiana, other than the United States government; or
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> (2) the property is shipped from an office, a store, a warehouse, a factory, or other place of storage in this state and the purchaser is the United States government.
>
> **Gross receipts derived** from commercial printing as described in IC 6-2.5-1-10 and **from the sale of computer software shall be treated as sales of tangible personal property for purposes of this chapter**.
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> (f) Sales, other than receipts from intangible property covered by subsection (e) and sales of tangible personal property, are in this state if:
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> (1) the income-producing activity is performed in this state; or
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> (2) the income-producing activity is performed both within and without this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.
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> (**Emphasis added**).

It is important to note that IC 6-3-2-2(e) refers to "computer software," as opposed to "prewritten computer software." Only "prewritten computer software" is considered tangible personal property for purposes of sales tax under IC 6-2.5-1-27. However, by specifically providing that "computer software," a more expansive term, is tangible personal property for purposes of calculating gross receipts, the intent of IC 6-3-2-2(e) is to capture all computer software, including custom software and not just that which is prewritten.

The Department's regulation found at 45 IAC 3.1-1-38 further provides:

> For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:
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> (1) Maintenance of an office or other place of business in the state.
>
> (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods.
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> (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution.
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> (4) Rendering services to customers in the state.
>
> (5) Ownership, rental, or operation of a business or of property (real or personal) in the state.
>
> (6) Acceptance of orders in the state.
>
> (7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income.
>
> As stated in Regulation 6-3-2-2(b)(010) [45 IAC 3.1-1-37], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC 6-3-2-2(b)-(n).

Of relevance here is 15 USC § 381 (P.L. 86-272), which prohibits states from imposing a net income tax on a foreign taxpayer if the foreign taxpayer's only business activity within that state is the solicitation of sales. As such, a state may not impose an income tax on income derived from business activities within that state if those activities do not exceed the mere solicitation of sales.

By way of further explanation, the U.S. Supreme Court established that a de minimus amount of non-solicitation activity also would not cause a corporation to lose the exemption from taxation afforded by P.L. 86-272. *Wisconsin Dept. of Revenue v. William Wrigley, Jr.*, 505 U.S. 214, 228-29, 112 S.Ct. 2447, 2456-57 (1992). However, the Court stated that a company would lose the protection of P.L. 86-272 if it performs an activity that establishes a nontrivial additional connection with the taxing state. *Id*. at 231-32.

The provisions outlined in regulation 45 IAC 3.1-1-38 constitute a minimum threshold of activity in which an entity must engage to establish nexus with the state such that taxation would not be prohibited under P.L. 86-272. Based upon the information provided and the Department's understanding of the information, Company's Indiana activities do not exceed solicitation of sales, even with the transfer of software into Indiana. However, if the Company performed more than a minimal amount of services in Indiana related to the software, such as maintenance or support, Company would exceed the protections of P.L. 86-272.

Notwithstanding the determination, if Company had nexus in Indiana, because Company is an S Corporation, it would be exempt from corporate income tax. IC 6-3-2-2.8. The S Corporation's activities would be attributed to shareholders and therefore the shareholders would be subject to Indiana individual income tax on the S Corporation's activities under IC 6-3-2-2. However, S Corporations have a requirement to file a composite adjusted gross income tax return on behalf of all its shareholders who are not residents of Indiana. IC 6-3-4-13. This relieves the nonresident shareholders participating in the composite return from the obligation to file an individual adjusted gross income tax return, though the shareholders are permitted to file individual returns. The S corporation shall take credit for all withholding amounts attributed to nonresidents included in the composite return. Any overpayment or underpayment of tax shall be reconciled on Form IT-20S. (*See* IC 6-3-4-13 and Income Tax Information Bulletin #72).

RULINGS

Based on IC 6-3-2-2, Company is not doing business in Indiana by making a sale of software to Indianapolis Contract Manufacturer, unless the Company also performed more than a minimal amount of services in Indiana related to the software, such as maintenance or support, Company would exceed the protections of P.L. 86-272. Notwithstanding the determination, if Company had nexus in Indiana, as an S Corporation, the activities would be attributed to shareholders and therefore the shareholders would be subject to Indiana individual income tax on the S Corporation's activities under IC 6-3-2-2. However, Company must file a composite adjusted gross income tax return on behalf of all its shareholders who are not residents of Indiana.

CAVEAT

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer's facts and circumstances as stated herein are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this ruling a change in statute, regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.

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